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GRANTOR TRUSTS

Income Taxation and Planning Opportunities

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Grantor Trusts

- Trust treated as "owned" by the grantor (or another individual) for income tax purposes.
- Grantor trusts can be revocable or irrevocable
  - All revocable trusts are grantor trusts (unless you give someone the power to eliminate the settlor's power to revoke or modify)
- The owner pays tax on trust income.
- Distributions to beneficiaries do not pull out distributable net income (DNI) from the trust. Distributions are income tax-free to the beneficiaries since the owner pays the income taxes.
  - With Pennsylvania now conforming to the federal tax treatment of grantor trusts with tax years beginning on or after 1/1/25, all fifty states recognize federal grantor trust rules.
  - Note that New York and California treat certain incomplete gift non-grantor trusts (INGs) as grantor trusts.

IRC 671-678 – Grantor Trust Provisions

- § 671 Trust income, deductions, and credits attributable to grantors and others as substantial owners
    - Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual.
    - **IRC 672** – Definitions and Rules – Includes adverse party, non-adverse party, related or subordinate party, rule where power is subject to condition precedent and grantor treated as holding any power or interest of grantor's spouse.
        - These definitions are incredibly important to trust planning. An attempt to create a non-grantor trust if not properly handled will result in an unintended grantor trust.

IRC 671-678 – Grantor Trust Provisions

- **IRC 673** – Reversionary Interests - Generally, the grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion.

- **IRC 674** – Power to Control Beneficial Enjoyment – Generally, the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a non-adverse party, or both, without the approval or consent of any adverse party. This code section includes numerous exceptions to this rule.

IRC 671-678 – Grantor Trust Provisions

- **IRC 675** – Administrative Powers - The grantor shall be treated as the owner of any portion of a trust in respect of which he/she has:
  - Power to deal for less than adequate and full consideration, power to borrow without adequate interest or security or the grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year (shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor).
    - It is common to create a power to loan to the settlor to both create grantor trust status and to provide access to trust assets in an irrevocable trust plan. But what is “adequate security”?
  - General powers of administration**.** A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. The term “power of administration” means any one or more of the following powers: (A) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; (B) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or (C) a power to reacquire the trust corpus by substituting other property of an equivalent value.

IRC 671-678 – Grantor Trust Provisions

- **IRC 676** – Power to Revoke - A power to revest title in the grantor, exercisable by the grantor or a non-adverse party, or both, generally causes grantor-trust status.
- **IRC 677** – Income for Benefit of Grantor/Spouse -Income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a non-adverse party, or both, may be distributed to, accumulated for, or applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (except policies of insurance irrevocably payable for charitable purposes).
- **IRC 678** – Other Substantial Owner - A person other than the grantor may be taxed as owner of any portion of a trust with respect to which such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of IRC 671 to IRC 677, inclusive, subject a grantor of a trust to treatment as the owner thereof. This rule shall not apply with respect to a power over income if the grantor of the trust or a transferor (to whom IRC 679 applies) is otherwise treated as the owner.

Partial Grantor Trusts

- A trust need not be wholly grantor or wholly nongrantor. Ownership can apply to a specified portion.
  - A common way that this occurs is multiple people, not just the intended grantor, make gifts to a trust.
  - Another way is a trust having multiple Crummey power holders and the grantor trust status as to them is not superseded by the grantor's grantor trust status.
- A grantor can be considered to own a portion of a trust in the following ways:
  1. Ownership of some or all of the ordinary income portion.
  2. Ownership of some or all of the principal portion
  3. Ownership of a fractional share of all trust property.
  4. Ownership of some or all of the income from a specific trust asset.
- If the trust is a grantor trust for only a portion of the trust, the type of entity should indicate on page one of Form 1041 both "Grantor type trust " and either "Simple trust " or "Complex trust" depending on the provisions in the trust document. All items of income, deductions, and credits allocable to the nongrantor portion of the trust are reported on the Form 1041 under the normal reporting rules.

Income Tax Reporting

- **Standard reporting method**: File Form 1041 with the trust's EIN and include a grantor tax information letter reflecting all of the income, deductions and credits of the trust reportable by the grantor/owner. The grantor tax information letter should include the grantor/owner's name, address and social security number as well as the trust's name, address and EIN.
- Include a statement on page 1 of the Form 1041 such as "Pursuant to Reg. 1.671-4(a), all items of income, deduction and credit attributed to the grantor under IRC 671-678 are reported on the attached separate schedule."
- Reporting Schedules K-1 received from pass-through entities – to save preparation time and avoid having the information from multiple pass-through entities bunched together and reported as totals on the grantor/owner's individual income tax return, attach copies of K-1s to the trust's income tax return rather than inputting them and indicate on the grantor tax information letter that the K-1s will be reported on the grantor/owner's individual income tax return.

Income Tax Reporting

Alternative reporting methods: If the trust is treated as owned by one grantor/owner, per Reg. 1.671-4(b)(2), the trust may use either of the following methods instead of the previously described standard method:

1. **Grantor/owner's TIN provided to payor's of income**. Furnish the name and taxpayer identification number of the grantor/owner and the address of the trust to all payors of income and proceeds during the year. The grantor/owner must complete Form W-9 (Request for Taxpayer Identification Number and Certification) to provide the trustee with their name, TIN, and backup withholding information. The trustee must then forward this information from Form W-9 to all payors of income. This requirement is a prerequisite to electing the first optional alternative reporting method. These payors will file the appropriate Forms 1099 with the IRS. In this case, the trustee is not required to file Form 1041 or 1099. Because the address of the trust is provided to the payors, the trustee will receive the Forms 1099. The trustee is required to furnish a statement to the grantor pursuant to Reg 1.671-4(b)(2)(ii) and (iii)(B) that provides the information needed by the grantor/owner to compute their taxable income.

Income Tax Reporting

2. *** Trust's TIN provided to payors of income**. Furnish the name, TIN, and address of the trust to all payors of income. Upon receiving Forms 1099 from the payors, the trustee must file the appropriate Forms 1099 to report the income and gross proceeds to the IRS, with the trust considered to be the payor and the grantor/owner considered to be the payee. Similar types of income (e.g., all interest income) must be combined for the 1099 reporting. The trustee is required to furnish a statement to the grantor/owner pursuant to Reg 1.671-4(b)(2)(ii) and (iii)(B) that provides the information needed by the grantor/owner to compute their taxable income. The grantor/owner should not receive copies of the Forms 1099 filed by the trust.

*This second alternative method is available to trusts with more than one grantor/owner. The first alternative method is not.

- Trusts Not Qualifying to Use an Alternative Reporting Method: a common trust fund; a foreign trust; a qualified subchapter S trust (QSST); a trust having one grantor/owner if the grantor/owner has a fiscal year end; a trust with a grantor/owner who is not a United States person and a trust having one grantor/owner if the grantor/owner is an exempt recipient for information reporting.

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Grantor Trusts – Eligible S Corporation Shareholders

A grantor trust is an eligible S corporation shareholder as long as the grantor income tax status is in place (and provided the grantor/owner is a U.S. citizen or resident). Requirements to be met to maintain eligible S corporation shareholder status after grantor trust status ceases differ depending on the reason for the end of the grantor trust status.

- **Grantor releases the power that is causing grantor trust status -** the trust can only be an eligible S corporation shareholder for 2 1/2 months unless an ESBT (Electing Small Business Trust) or QSST (Qualified Subchapter S Trust) election is made.

- **Death of grantor of an irrevocable trust –** the trust can continue as an S corporation shareholder for two years after the date of the grantor's death. Before the expiration of the two-year period, the trust will need to make a QSST election, an ESBT election or dispose of the S corporation stock (via sale, redemption or distribution).

- **Death of grantor of a revocable trust –** if an IRC 645 election is made to include the trust in the grantor's estate's income tax return, then, since an estate is a permitted shareholder of an S corporation, during the reasonable period of administration of the estate, there is no S corporation eligibility problem. Without an IRC 645 election, the formerly revocable trust can continue as an S corporation shareholder for two years after the date of the grantor's death. Before the expiration of the two-year period, the trust will need to make a QSST election, an ESBT election or dispose of the S corporation stock (via sale, redemption or distribution).

Change in Grantor Trust Status

- A new EIN must be obtained for the trust when grantor trust status ceases since the grantor is treated as having transferred assets to a new trust. Two separate tax returns may be needed for the trust – one from January 1 to the date grantor trust status ceases (under the grantor trust EIN) and one from the day after grantor trust status ceases to December 31 (under the non-grantor trust EIN).

- The transfer to the new trust generally does not result in gain or loss recognition on the transfer because there is typically no consideration received by the grantor. However, if the trust property is subject to indebtedness, the grantor may have cancellation of indebtedness income.

- In Rev. Rul. 77-402, the IRS held that a trust previously treated as a grantor trust became a nongrantor trust when the grantor renounced the powers that caused classification as a grantor trust. Because the trust included partnership interests for which liabilities exceeded basis, the grantor was considered to have debt relief, and therefore, taxable income, on the transfer.

PLANNING OPPORTUNITIES

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Planning – The "Tax Burn"

- The grantor's payment of the income tax attributable to grantor-trust income is generally not an additional taxable gift to the trust beneficiaries. Rev. Rul. 2004-64
- Payment of the income taxes by the grantor allows the trust to grow "tax-free" while creating a spend-down estate tax planning benefit for the grantor.
- Potential for tax savings due to the compressed tax brackets of trusts.
- It is important to determine whether or not the grantor has adequate liquidity to support this planning and that the tax burden from the trust will not be unsustainable. The importance of this cannot be overstated. Forecasts over the grantor's life expectancy, if not longer, should be prepared. Don't rely solely on a tax reimbursement clause as that has to be in the trustee's discretion. If the trustee is a family member, more than occasional use of the reimbursement clause may look like an implied agreement and could attract an IRS or creditor challenge.

Tax Reimbursement Clause

- Allowing the trustee of a grantor trust to have the *discretionary a*uthority to reimburse the grantor for income taxes incurred as a result of the trust's income being included in the grantor's income tax return, does not, by itself, cause inclusion of the trust in the grantor's gross estate.

- Even where discretionary reimbursement is permitted, state law, fiduciary standards, creditor issues, and the grantor's overall estate plan should be considered.

- If the reimbursement is mandatory under either the trust instrument, or applicable state law, the grantor is treated as retaining the right to have trust property used to discharge the grantor's personal tax liability. Rev. Rul. 2004-64 concluded that this can cause inclusion of the entire trust in the grantor's gross estate under §2036(a)(1).

- Consider naming an independent trustee. Try to avoid any regularity in exercise. Have the CPA prepare a letter explaining the assumptions of the calculated amount for reimbursement. Have an attorney review the letter for compliance with both the trust instrument and any relevant state law. Is reimbursement calculated on a marginal or average basis? Is state income tax included as well?

Substitution Power - IRC 675(4)(C) – Tax Basis Planning

- A properly drafted power to reacquire trust property by substituting property of equivalent value can trigger grantor-trust status.
- Rev. Rul. 2008-22 concluded that such a power, by itself, does not cause estate inclusion under §§2036 or 2038 if specified safeguards are present.
- Before death, the grantor may consider exchanging high-basis assets for low-basis, highly appreciated trust assets of equal value. Have the documents set up and a line of credit in advance so that, if necessary, the swap can be effectuated quickly.
- The appreciated assets can then be held directly by the grantor and potentially receive a §1014 basis adjustment if included in the grantor's gross estate.
- The fair market values of the assets being exchanged should be appropriately determined (valuation, appraisal) and documented to show that the grantor did not make a gift to the trust and the trust did not transfer excess value to the grantor.
- Consider using a Wandry or other adjustment mechanism if hard to value assets are involved.

Intentionally Defective Grantor Trust (IDGT)

- A trust for which transfers to it are complete for estate tax purposes, but incomplete for federal income tax purposes is referred to as an intentionally defective grantor trust (IDGT). It is ”defective” for income tax purposes (still taxed to the grantor), but effective for estate tax purposes (removed from the grantor’s gross estate). complex trusts.

- In addition to the “tax burn” benefits mentioned on the previous slide, the trust assets and the appreciation of the trust assets after the date of transfer to the trust are removed from the grantor's gross estate.

- Transactions between the grantor and the trust are ignored for income tax purposes. (Rev. Rul. 85-13) Therefore, the grantor can sell assets to or purchase assets from the trust, enter into rental arrangements with the trust, etc. without recognizing gain/loss or income on the transactions.

Sales to Intentionally Defective Grantor Trusts - IDGTs

- Grantor makes a completed gift to establish meaningful trust equity (10% of value of asset to be sold is common but is not a rule based in law, it is merely conjecture.)
- The grantor sells an asset to an IDGT in exchange for a promissory note using the AFR (applicable federal rate).
- An interest in a closely-held business or a minority interest in a family limited partnership, which could be discounted in determining the fair market value, are assets that should be considered for this technique.
- The trust is “defective” in that for income tax purposes the income is still taxed to the grantor but for estate tax purposes, the trust assets are not included in the grantor’s estate.
- In addition, since the trust is considered as owned by the grantor for income tax purposes, the sale is not a taxable event, and the interest is neither taxable to the grantor nor deductible by the trust.
- The sale enables the grantor to “freeze” the value of the sold assets so that all of the future appreciation post-sale and earnings in excess of the interest rate cost are outside of the grantor’s estate.
- Recommend reporting the sale transaction on the grantor’s Form 709 as a non-gift transaction for the year of the sale to start a statute of limitations on the transaction.

Dynasty Trusts

- Sometimes drafted as grantor trusts to get the “tax burn” benefits.
- A long-term trust that is used to pass significant wealth through multiple generations without the imposition of gift, estate or GST taxes (exemptions used upon funding).
- The trust term continues as long as legally possible (under state law). Select a state that has a longer rule against perpetuities (RAP – how long a trust may last) if the home state law is not favorable.
- Trustee may have the discretion to make income and principal distributions to the beneficiaries. The dynasty trust might be structured, if state law permits, as a DAPT, hybrid DAPT, SLAT or SPAT.
- Protection against marital and creditor problems of the beneficiaries.
- Trust can be funded during lifetime or at death but funding during lifetime with appreciating assets removes the post-transfer appreciation from the grantor’s estate. The trust may also provide asset protection which may be the most important benefit of the plan.

Other Grantor Trusts

- Grantor Retained Annuity Trusts (GRATs) – treated as grantor trusts during the annuity period and often have provisions to continue grantor trust treatment after the annuity period is over.
- Qualified Personal Residence Trust (QPRT) - treated as grantor trusts during the annuity period and often have provisions to continue grantor trust treatment after the annuity period is over.
- Spousal Lifetime Access Trust (SLAT) – typically are drafted as grantor trusts.
- Revocable Trusts – grantor trusts during the grantor's lifetime due to the grantor's power to revoke (unless you give someone the power to eliminate the settlor's power to revoke or modify)

Questions?

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